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SUBJECT: PRICE RISES CONFRONT NEW GOVERNMENT

¶1. Summary: Although Croatia's average annual inflation rate for 2007 was 2.9%, slightly below the 2006 rate, the year-on-year rates in October, November and December were the highest since 2000 and 2001 at 4.3-5.8%. The Croatian National Bank expects inflation for 2008 to be as high as 4.5%. The price increases have caused concern among Croatians, and the trade unions have pushed the government to act. The government, unions, and employers will form a commission to monitor the price increases and propose measures to the government. The government's ability to influence prices is limited, but economists are concerned that this pressure could lead to public sector wage and pension hikes. Given Croatia's high levels of state employment and the large number of pensioners, such moves could affect the rest of the economy and further reinforce already strong inflationary expectations. End summary.

¶2. Croatia's annual inflation rate dropped to 2.9% for 2007 from a rate of 3.2% for 2006. In the last quarter of 2007, however, Croatia experienced its highest inflation in the last seven years. According to Croatia's Central Bureau of Statistics, prices were 4.3% higher in October, 4.6% higher in November, and 5.8% higher in December as compared to the same months in 2006. Rises in the prices of food and fuel drove much of the overall rise. Comparing November 2007 to November 2006, food prices rose 8.2% while the price of fuel for automobiles rose 10.5%. Comparing December 2007 to December 2006, food prices were 11.4% higher and auto fuel prices, 9.7% higher. On top of these hikes, for Zagreb residents, January 1st brought an increase in the price of water (22% over January 2007), public transportation (38%), and utilities (50%).

¶3. Given the acceleration of inflation at the end of 2007, Croatian National Bank Governor Zeljko Rohatinski described as unrealistic the estimates of some analysts that inflation would be 3.0-3.5% for 2008. At a news conference in late December, he said he expected an inflation rate of 4.5% for 2008, and that this was neither a catastrophe nor a cause for panic. He also cautioned against using the price increases at the end of 2007 and the projections for 2008 as a reason for indexing wages, prices, or interest rates.

¶4. According to a survey conducted the first week of January, many Croatians regard these actual and expected price increases as the top issue of concern for the government. The trade unions also are focused on the price increases, and the lack of commensurate salary increases. By union calculations, price levels in Croatia are 70% of those in the EU, while the average salary in Croatia is 26% that of the EU. The unions have pressed employers to increase wages, but with little success. They also warned the government they would organize protest rallies if the

government did not act to increase the minimum wage and pensions and otherwise take measures "to protect living standards." On occasion, union leaders individually called for specific measures such as indexing all salaries to inflation, setting limits on price increases, and returning recently raised prices to their old levels.

¶ 15. In response, PM Sanader and other government representatives met with representatives of the unions and the Croatian Employers Association on January 15. Sanader said the economic situation in Croatia was "difficult but not alarming." He said the government, employers, and trade unions would establish a commission to monitor price increases and their effect on living standards and to propose measures for the government to consider. Sanader also announced the government would host a meeting with the unions and employers to raise the level of social dialog on matters such as the minimum wage, the privatization process, social and employment policy, fighting the grey economy, and increasing economic competitiveness. As a third step, he said the government would meet with cities and municipalities and encourage them to consider the effect on residents before they raise the price of utilities and municipal services.

¶ 16. Croatia's largest union, the Union of Autonomous Trade Unions of Croatia (UATUC), announced they would organize a protest rally on April 12, giving the government three months to raise the minimum wage. Leaders of the other unions said they would wait to see if the measures proposed at the meeting with Sanader produced results before joining the UATUC in organizing the protest.

¶ 17. Comment: The unions' efforts succeeded in making inflation one of the first topics Sanader's new government had had to publicly address. Despite some of the unions' calls for government intervention, Sanader's response was measured, essentially promising only further dialog and the continuation of economic reforms. However, indications are that Croatia will face higher inflation and slower growth for 2008, beginning already in the first quarter of the year. As Croatians feel the effects of this worsening situation, it may become more difficult for Sanader's new coalition government to resist pressure for intervention on wages and pensions. End comment.

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